

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Wright Analyst: William Koch Bill Number: SB 45  
Related Bills: See Legislative History Telephone: 845-4372 Introduced Date: December 8, 2010  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Internet Gambling Consumer Protection & Public-Private Partnership Act Of 2011/Require FTB To Collect Withholding, Taxes, Fees From Hub Operators

### SUMMARY

This bill would do the following:

- Allow internet gambling within California,
- Require the Franchise Tax Board (FTB) to create a form to allow gaming operators to report players' winnings electronically to the FTB, and
- Authorize the gaming operator to withhold state income tax from gambling winnings.

This analysis will address the bill only as it impacts the department and its programs, operations, and state income tax revenue.

### PURPOSE OF THE BILL

According to the legislative findings within the bill, the purpose is to protect the interests of Californians participating in internet gambling and, among other things, to increase compliance with state income tax laws.

### EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would be effective and operative immediately upon enactment.

### POSITION

Pending.

### ANALYSIS

#### FEDERAL/STATE LAW

#### Income Tax and Withholding

Existing state law imposes tax on the income earned by individuals, estates, trusts, and certain business entities. Tax is imposed on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California. The tax for individuals is computed on a graduated scale at rates ranging from 1 percent to 9.3 percent.

Board Position:

\_\_\_\_\_ S \_\_\_\_\_ NA \_\_\_\_\_ NP  
\_\_\_\_\_ SA \_\_\_\_\_ O \_\_\_\_\_ NAR  
\_\_\_\_\_ N \_\_\_\_\_ OUA \_\_\_\_\_ X PENDING

Department Director

Date

Selvi Stanislaus

02/16/11

Current state law requires the FTB on an annual basis to provide the Employment Development Department (EDD) with wage withholding tables to be used by employers to withhold taxes on wages paid to their employees. The tables are based on the estimated amount of tax due on the wages paid by the employer. Legislation enacted in 2009 requires the amount determined for the withholding tables to be increased by 10 percent. In addition, employers required to withhold tax on supplemental wages can use a method that applies a fixed rate to the supplemental wage amount. This rate is 6.6 percent for supplemental wages other than stock options and bonus payments. The rate of withholding for stock options and bonus payments is 10.23 percent.

Taxpayers are required to make estimated tax payments if the amount of taxes withheld or otherwise available for a taxable year is less than the amount due. Penalties are imposed if the estimated taxes are underpaid.

## **Gaming**

Under federal law, the Unlawful Internet Gambling Enforcement Act of 2006 (UIGEA), prohibits a person engaged in the business of betting or wagering from accepting methods of payment, including credit cards, electronic fund transfers, and checks in connection with the participation in "unlawful Internet gambling." Unlawful Internet gambling is defined as a bet or wager that knowingly involves the use of the Internet where such a bet is unlawful under any applicable federal or state law in the state or tribal lands in which the bet or wager is initiated, received, or otherwise made. UIGEA exempts certain transactions from this prohibition, including bets or wagers that are initiated and received exclusively within a single state and the bet or wager is expressly authorized and played in accordance with the laws of that state. The state law must include age and location verification requirements and data security standards designed to prevent access to minors and persons located outside of that state. The law additionally stipulates that the bet or wager may not violate four separate federal laws: the Interstate Horseracing Act, the Professional and Amateur Sports Protection Act, the Gambling Devices Transportation Act, and the Indian Gambling Regulatory Act (IGRA).

The Gambling Control Act of 1997 established the California Gambling Control Commission to regulate legal gaming in California and the Bureau of Gambling Control within the Department of Justice to investigate and enforce controlled gambling activities in California. It prohibits gambling in a city or county that does not have an ordinance governing certain aspects of the operation of gambling establishments, including the "hours of operation" of gambling establishments.

The California Constitution permits Indian tribes to conduct and operate slot machines, lottery games, and banked and percentage card games on Indian land if (1) the Governor and an Indian tribe reach agreement on a compact; (2) the Legislature approves the compact; and (3) the federal government approves the compact. There are currently 67 active Tribal-State Gaming Compacts.

## THIS BILL

This bill would allow hub applicants that meet specific background requirements to submit an application to the Gambling Control Commission (Commission) for a 20-year contract to operate online gaming hubs in the State of California. The Commission would oversee the hubs, which would be required to regulate the Internet gaming sites and withhold income tax in an amount equal to 5 percent of a registered player's tournament winnings if the amount of winnings, after deduction of the tournament charge, is in excess of \$600 and if those winnings are also 300 times the tournament charge. Mandatory tax withholding is determined on a tournament-by-tournament basis. The hub operator would also be required to remit the amount of money withheld from a registered player's tournament winnings to the FTB directly from the registered player's account.

The FTB would be required to publish a form annually that would allow hub operators to report the winnings of its members to the state. This form would include a registered player's name, social security number, the total amount deposited into a player's gaming account during the year, and the amounts of a player's total winnings and losses during the year. This form would be filed electronically by the hub operator with the FTB.

The FTB would be required to submit a request for costs needed to implement this bill for the upcoming fiscal year to the Senate Committee on Budget and Fiscal Review, the Assembly Committee on Budget, the Senate and Assembly Committees on Governmental Organization, and the Department of Finance by March 31 of the preceding fiscal year.

State agencies would have the authority to adopt rules to implement the duties that would be required under this bill. As such, the FTB may adopt rules to collect and process the taxes withheld, collected, and/or remitted by hub operators and gamers.

This bill would create the Internet Gambling Fund. In exchange for the state allowing a hub operator to do business in California, the hub operator would be required to transfer a minimum of 10 percent of its gross revenue to the Treasurer on a monthly basis, and the Treasurer would be required to transfer that money to the Controller to be deposited into the Internet Gambling Fund.

The bill would define various terms including the following:

- "Commission" means the California Gambling Control Commission.
- "Gambling" means to deal, operate, carry on, conduct, maintain, or expose for play any game for money.
- "Game" means any gambling game.
- "Gross revenues" means the total amount of money paid to a hub operator pursuant to activities authorized under the chapter that would be created by this bill. "Gross revenues" would not mean player wagers or deposits.
- "Hub" means all facilities and software used to facilitate activities that would be allowed by this bill.
- "Hub operator" means a person that has a contract with the state that would require the person to offer authorized games to registered players on the Internet.

- "Person" means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, government, governmental subdivision, agency, or instrumentality, public corporation, or any other legal or commercial entity.
- "Registered player" means a player who has registered with a hub operator to play authorized games.
- "Tournament" means a competition in which registered players play a series of authorized games to decide the winner.
- "Tournament winnings" means the amount of any prize awarded to a registered player in a tournament.

### IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill would create the Internet Gambling Fund. According to the legislative intent language in the bill, the fund would be used to reimburse the various state agencies required to implement this bill. The bill fails to specify how the FTB would receive funding for the department's startup costs associated with creating a system to accept withholding payments and for the ongoing costs required to implement the bill. It is recommended that the author include specific funding language for the FTB to receive start-up funding for the costs of implementing the bill. Lack of funding language would delay or possibly prevent FTB from implementing the provisions of the bill.

The provisions of this bill lack clarity on two significant points:

1. The percentage of winnings a hub operator is required to withhold if a player engages in non-tournament play.
2. When the hub operator is required to remit tax proceeds withheld to the FTB.

Lack of clarity regarding whether tax proceeds generated from non-tournament play would be subject to the bill's withholding requirements and failure to specify the tax proceeds remittance due date could lead to confusion between taxpayers and the department and would complicate the administration of this bill. The author may wish to amend the bill to incorporate the sections of the Revenue and Taxation Code that allow the FTB to withhold tax proceeds on non-wage sources to establish withholding amounts and due dates consistent with current withholding at source laws and regulations.

This bill would require the hub operator to retain all books, records, documents, financial information, and financial reports for one year after they are created. This would include the information used to prepare the annual form that is electronically sent to the FTB. It is unclear if the FTB would have access to the hub operator's data after one year to verify whether the information provided on the form sent to the FTB is correct. Without access to their own records related to withholding amounts sourced through internet gaming winnings, gamers may be prevented from responding to inquiries or audits from the FTB, and could complicate the administration of this bill. It is recommended that the author amend the bill to require the hub operator to retain the financial information consistent with existing retention requirements for such data.

## **LEGISLATIVE HISTORY**

SB 40 (Correa, 2011/2012) would establish a framework to authorize intrastate Internet poker and would require the Department of Justice, in consultation with the California Gambling Control Commission, to adopt regulations governing the intrastate play of poker games on the Internet. SB 40 is currently referred to be heard in the Senate Committees on Government Organization and Public Safety.

SB 1485 (Wright, 2009/2010) was nearly identical to this bill. SB 1485 failed to pass out of the Senate Committee on Government Organization.

AB 293 (Mendoza, Stats. 2009, Ch. 233) prohibited gambling enterprises from cashing checks drawn against any federal, state, or county fund, and deleted a requirement that copies of dishonored or uncollectible checks be sent to the FTB.

AB 1385 (Battin, et al., Stats. 1999, Ch. 874) clarified the Governor's role in entering into memoranda of understanding with Indian tribes and ratified 57 Tribal-State Gaming Compacts.

SB 8 (Lockyer, Stats. 1997, Ch. 867) prohibited the ownership or operation of a gaming club without first obtaining a valid registration from the Attorney General and created the California Gambling Control Act to regulate authorized gaming rooms and tribal gaming facilities within California.

## **OTHER STATES' INFORMATION**

*Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* laws do not provide a similar treatment for Internet gambling as would be allowed by this bill. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

## **FISCAL IMPACT**

This bill would enhance compliance with payment of income tax for income earned from Internet gambling and would create a new form that the department would administer. The costs would be generated from the withholding procedures required by this bill and would be approximately \$4.21 million (24PYs) in the first year for unreimbursed start-up costs and approximately \$1.86 million (24 PYs) annually for ongoing operations, which could be reimbursed through the Internet Gambling Fund established by this bill.

Suggested language is provided in Amendment 1 to fund the department's startup implementation costs for this bill. If this bill is enacted without appropriation language, the department will pursue a budget augmentation ("legislative budget change proposal") through the normal budgetary processes, which could delay implementation of the bill's provisions to July 1, 2012. If approval of a legislative budget change proposal is denied, the department may be unable to implement the provisions of this bill.

## ECONOMIC IMPACT

### Revenue Estimate

Estimated Revenue Impact* of SB 45 Internet Gambling For Tax Years Beginning On or After June 30, 2011 Enactment Assumed After June 30, 2011		
2011-12	2012-13	2013-14
+ \$10,000,000	+ \$21,000,000	+ \$27,000,000

\* This estimate does not include revenue from the percentage of hub operators' gross revenues owed pursuant to section 19990.58 as proposed by this bill.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 45  
As Introduced December 8, 2010

AMENDMENT 1

On page 51, after line 2, insert:

SEC. 5. (a) The sum of four million two hundred twelve thousand dollars (\$4,212,000) is hereby appropriated to the Franchise Tax Board in augmentation of item 1730-001-0001 of the Governor's Budget, Chapter XX, Statutes of XXXX.

(b) Implementation of the withholding procedures authorized by this bill is contingent upon receipt of an appropriation.